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FROM: Louis Lembo/Art Padoan - Business Planning

SUBJECT: **BAT and American Tobacco Merger**

A merger of BAT and American Brands' domestic and international tobacco operations would provide BAT with the following benefits:

- Gain additional scale in the U.S. discount category in preparation for a high excise tax environment.
- Attain the leadership share in the profitable U.K. market.
- Increase worldwide tobacco operating income by approximately 40%.
- Improve profitability and cash flow through the potential elimination of \$195 million in American's domestic manufacturing and sales force costs.
- Provide scale economies via consolidation of B&W and American's U.K. operations.
- Enhance ability to build global brands including Pall Mall, B&H and Lucky Strike.
- Target Lucky Strike Filters at young adults in the U.S. using image and a discount price point.
- Reduce exposure to Pound Sterling and U.S. \$ currency translation fluctuations.
- BAT is not highly leveraged. Additional debt can be taken on to finance an acquisition of this size.

Domestic Tobacco Volume and Share Trends: Both B&W and American domestic tobacco unit volumes are forecast to decline at modest annual rates over the plan period, as falling premium volume is offset by small discount gains. The combined premium volume decline rate will be 15%. With such high premium volume erosion, BAT's objective for gaining control of American would be to gain scale in the discount category in preparation for a high taxation environment. B&W's share of the discount category would grow from 18% in 1993 to almost 32% in 1994.

Domestic Tobacco Unit Volume

	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>C.A.G.</u>
<u>Brown & Williamson</u>							
Premium	18.3	19.4	14.5	12.8	11.0	9.8	(11.7)%
Discount	32.2	34.8	33.4	33.1	33.7	33.4	0.7%
Total	50.5	54.2	47.9	45.9	44.7	43.2	(3.1)%
<u>American Tobacco</u>							
Premium	15.0	13.7	9.6	7.7	6.5	5.2	(19.1)%
Discount	16.1	17.1	17.2	18.4	18.4	18.3	2.6%
Total	31.1	30.8	26.8	26.1	24.9	23.5	(5.4)%
<u>Combined</u>							
Premium	33.3	33.1	24.1	20.5	17.5	15.0	(14.7)%
Discount	48.3	51.9	50.8	51.5	52.1	51.7	1.4%
Total	81.6	85.0	74.7	72.0	69.6	66.7	(4.0)%
Share of Industry	17.5%	18.0%	18.0%	17.8%	17.7%	17.4%	
<u>Share of Category</u>							
Premium	11.5%	10.8%	9.7%	8.7%	7.9%	7.2%	
Discount	27.7%	31.5%	30.7%	30.4%	30.1%	29.3%	

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Domestic Brands: B&W's business has relatively little overlap with American. B&W would gain premium niche brands ultra low tar Carlton and non-filter Pall Mall.

Lucky Strike - BAT will gain the Lucky Strike trademark in the U.S., the only important market they do not already sell the brand. It had acquired the rights in France to Lucky Strike and Pall Mall in a swap with American for the B&H trademark in duty paid markets of the European Community and European Free Trade Area in June 1993. BAT has had some success in attracting young adults to Lucky Strike in important markets such as Japan and Germany. B&W may try to position Lucky Strike as a low price alternative young adult brand in the U.S. with a strong counter culture image. Currently both B&W and American have very little representation in the 18-24 year old category. B&W has about 2% of 18 to 24 year old smokers and American has only 1%.

Discount - B&W will gain a stable of discount products to better position themselves in a high FET environment, including viable branded discount trademarks Misty and Montclair, and private label products Prime, Private Stock and Summit. B&W is currently not in the private label business and depends on its GPC trademark as its all purpose low price product. The addition of the private label business would free B&W to position GPC as a branded product like Basic and Doral, while using private label as its price fighter.

A combined domestic product line would look like this: (B&W, American)

Premium Menthol	Premium Non-Filter	Premium Ultra-Low Tar	Premium Charcoal Fltr	Other Premium	Branded Discount	Private Label
Kool	Pall Mall	Carlton	Tareyton	Capri	GPC Approved	Prime
	Lucky Strike	Barclay		Raleigh	Viceroy	Private Stock
				Belair	Raleigh Extra	Summit
					Savannah Lights	
					Montclair	
					Misty	
					Malibu	
					Lucky Strike Fltrs	
					American	
					Riveria (Menthol)	

Gallaher Tobacco Ltd.: It is in the international arena that BAT would realize the greatest benefits from acquiring American's tobacco operations. American's Gallaher division would give BAT the leading share in the U.K., one of the largest markets in Europe and BAT's home base of operations. Industry unit volume in the U.K. declined by 6.2% in 1993 to 79 billion units.

Gallaher is the market leader in the U.K. with a 1993 share of 39.8%, down 1.7 share points versus 1992. Key brands include B&H, Silk Cut and Berkeley. B&H and Silk Cut are the top two brands in the U.K. with 1993 market shares of 15.3% and 9.9%, respectively. Imperial Tobacco is the second largest company with a market share of 35%.

Despite being the industry leader, Gallaher has had its share of trouble. Its market share slipped by 2 points in 1992 (43.5% to 41.5%). In 1993, Gallaher's good fourth quarter performance was due largely to advance purchasing by the trade. This was brought on by an additional tax increase (2 in 1993) that was related to changes in the British government's budget calendar. Reflecting the trade buying, Gallaher's fourth quarter cigarette unit volume increased 14.2% in the U.K., its total volume including exports increased 6.7%. During 1993, the company addressed the growing popularity of discount brands by introducing a value line extension called B&H Super Kings which ended 1993 with a 2.8% market share.

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Gallaher is now American's largest profit center accounting for 33% of American's operating income in 1993. The company earned \$144 million (+7%) in the fourth quarter 1993 and \$489 million (-12%) for the full year 1993. Gallaher increased profits in 1993 by 8% in £ Sterling. Management has stated that it will be difficult to improve earnings in 1994 due to the significant amount of volume diverted from the first quarter 1994 to the fourth quarter 1993.

Gallaher's export units rose 32% during 1993, benefiting from the acquisition of the B&H trademark for the remainder of Europe.

A combination of BAT and American would also consolidate the international and U.S. rights to Pall Mall and Lucky Strike. As mentioned, Gallaher has the rights to B&H throughout Europe.

Currency Translation Benefit: Because BAT reports its earnings in £ Sterling, the acquisition of Gallaher would give the company protection from negative £/\$ currency fluctuations. Gallaher improved operating income by 8% in local currency, but because of the weakening of the pound against the dollar (\$1.55 in 1993 vs. \$1.77 in 1992), American reported a decline in Gallaher's U.S. \$ profits of 12% in 1993. Fluctuations in exchange rates for the British pound adversely affected American's consolidated 1993 revenues by \$1.4 billion and net income by \$61 million in 1993.

Manufacturing Capacity: It appears that B&W could absorb the production of American's unit volume by 1996. B&W produced approximately 92 billion units in 1993 by using 2 shifts. The Macon facility is currently undergoing a major expansion and modernization program that will increase its capacity to 150 billion units by 1996. It appears that it will be possible for B&W to close American's Reidsville facility and eventually shift production to Macon.

Major Facilities:

HQ:	Old Greenwich, Conn.	Louisville, KY
Manufacturing:	Reidsville, NC (1890)	Macon, GA (1978)
Other Key Export Plants:	UK (Gallaher)	Southampton, UK

<u>Domestic Manufacturing: (Units in Billions)</u>	<u>Reidsville</u>	<u>Macon</u>
Projected 1996 Domestic Unit Volume	26	46
Projected 1996 Export Unit Volume	<u>2</u>	<u>45</u>
Projected Total 1996 Units	28	91
Combined 1996 AMB/B&W to be produced at Macon		119
Current (2/94):	74(E)	110(F)
Planned Capacity by 1996:	74	150
<u>Overseas Manufacturing: (Units in Billions)</u>	<u>Gallaher</u>	<u>Southampton</u>
Current:	70(G)	27(H)
Planned by 1996:	N/A	55

Notes: (E) Average age of making equipment technology is 5 to 15 years old (Average speed: 6,900 cpm)

(F) Average age of making equipment technology is 5 to 10 years old (Average speed: 6900 cpm)

(G) Employs approximately 1,500 people (salary and hourly). Will close one UK plant and reduce employment by 670 jobs or 15% by March 1994.

(H) Employs 750 people. Currently testing 14,000 cpm makers.

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Cost Savings: If B&W elects to eliminate the maximum amount of costs, it could close American's Reidsville manufacturing facility and layoff all sales force, R&D and HQ administrative employees. The potential annual cost savings (excluding severance costs) could reach as high as **\$195 million** annually which would exceed American's 1993 operating income of \$169 million.

	American Tobacco	B&W
<u>Manufacturing Manpower Estimates:</u>		
Manufacturing		
Hourly	1,075(A)	1,844(B)
Salaried	<u>205</u>	<u>356</u>
Total	<u>1,280(C)</u>	<u>2,200(D)</u>
R&D	<u>64</u>	<u>210</u>
<u>Estimated Annual Cost (\$ Millions)</u>		
Hourly	\$64	\$118
Salaried (\$50K salary + \$25K benefits)	<u>\$15</u>	<u>\$27</u>
Total Manufacturing	<u>\$79</u>	<u>\$145</u>
R&D (\$70K salary + \$35K benefits)	<u>\$7</u>	\$23
Notes: (A) \$20.93 Base Hourly Wage Rate + 37% Benefits		
(B) \$22.35 Base Hourly Wage Rate + 38% Benefits		
(C) Planned 10% Reduction (1,150)		
(D) Reductions to be announced within 60 days		
<u>Sales Force Estimates</u>		
Field Sales Force (Sales Reps)	820	1,148
(All Other)	<u>260</u>	<u>382</u>
Total Full Time	<u>1,080</u>	<u>1,530</u>
Part-Time Merchandisers	<u>400</u>	<u>470</u>
Est. Total Annual Calls in Millions (S/R's only):	1.5	2.2
Percent of PM-USA Total:	(33)	(44)
<u>Estimated Annual Cost (\$ Millions)</u>		
Sales Reps (\$50K salary + \$25K benefits)	\$62	\$86
All Other (\$75K salary + \$37.5K benefits)	<u>\$29</u>	<u>\$43</u>
Total Full Time	<u>\$91</u>	<u>\$129</u>
Part-Time Merchandisers	<u>\$8</u>	<u>\$9</u>
Total Sales Force	<u>\$99</u>	<u>\$138</u>
Total HQ Administration (240 employees @ \$50K + \$25K Benefits)	<u>\$17</u>	
Potential Annual Cost Savings (Excluding Severance Costs)	<u>\$195</u>	
Total U.S Employees	3,060	4,600

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BAT Industries and American Tobacco

Income from Operations Analysis: A merger of BAT worldwide tobacco with American Brands' tobacco divisions could increase BAT's IFO by about 40% (excluding any calculations for severance, restructuring, interest expense, acquisition costs, etc.). As detailed on the preceding page, there is the potential to save \$195 million in annual operating costs if BAT completely shuts down American's factories, eliminates its sales force and closes its administrative offices. Additional cost savings may be obtained by consolidating BAT and Gallaher manufacturing operations in the U.K.

	<u>1993</u>	<u>1994 (E)</u>	<u>1995 (E)</u>	<u>1993 - 1995 C.A.G. %</u>
BAT Tobacco IFO (All Yrs. Est.)				
B&W	£339	£352	£310	(4.4)%
BATCO	505	533	560	5.3%
Brazil	30	30	30	--
Germany	65	75	80	10.9%
Brand Swap	135	=	=	--
Total Tobacco	£1,074	£990	£980	(4.5)%
BAT Financial Services IFO	£728	£848	£933	13.2%
Total BAT IFO	£1,802	£1,838	£1,913	3.0%
AMB Tobacco IFO (1993 Actual)				
U.S. (ATC)	\$169	\$169	\$125	(14.0)%
Gallaher	\$489	\$518	\$546	5.7%
Total Tobacco	\$658	\$687	\$671	1.0%
All Other AMB Divisions IFO	\$844	\$911	\$984	8.0%
Total AMB IFO	\$1,502	\$1,598	\$1,655	5.0%
Combined BAT/AMB Tobacco IFO				
BAT Tobacco (Est.)	£1,074	£990	£980	
AMB Tobacco (Est.) Translated £	£424	£443	£433	
Total Combined Tobacco IFO	£1,498	£1,433	£1,413	
% Increase - BAT vs. Combined	+39.5%	+44.8%	+44.2%	
<i>£/\$ Exchange Rate</i>	\$1.55	\$1.55	\$1.55	

American Tobacco and Gallaher - Identifiable Net Assets

	<u>1992</u>	<u>1991</u>	<u>1990</u>
Domestic Tobacco	\$1,251	\$1,691	\$1,734
Gallaher	807	764	656
Total Tobacco Assets	\$2,058	\$2,455	\$2,390

American Brands P/E Ratio and Potential Purchase Price

If the purchase price of American's tobacco divisions is equal to the company's current P/E ratio of 11.0, BAT would pay approximately \$4.4 billion (1993 total tobacco estimated after tax income of \$400 million, operating income of \$658 million).

According to the balance sheet notes in BAT Industries 1992 annual report, the company has additional borrowing facilities of £3.6 billion (\$5.6 billion) that were not utilized at the balance sheet date (12/31/92).

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BAT Debt Ratios

Debt to Equity Ratio: BAT's debt to equity ratio appears conservative and in line with American Brands' at 0.82 to 1. If BAT were to take on an additional \$5 billion (£3.2 billion) in long term debt, its debt to equity ratio would double to 1.62 to 1, which would still be below RJR but slightly above PM.

Times Interest Earned: BAT had a conservative times interest earned ratio of 7.8 to 1 at 12/31/92.

BAT Industries	12/31/92	12/31/91	% Change
Current Portion of LT Debt	£208	£167	24.6%
Current Liabilities	£2,096	£1,655	26.6%
Long Term Debt	£2,593	£1,924	34.8%
Other and Reserves	£661	£575	15.0%
Total LT Debt	£3,254	£2,499	30.2%
Total Stockholders' Equity	£3,975	£3,079	29.1%
Long Term Debt to Equity Ratio	0.82	0.81	
AMB LT Debt to Equity Ratio*	.066	.065	
RJR LT Debt to Equity Ratio*	1.93	2.37	
PM LT Debt to Equity Ratio**	1.41	1.29	

* Per 9/30/93 Balance Sheet, ** Per 12/31/93 Press Release.

Herfindahl Index: It does not appear that the merger of B&W and American will alter the tobacco industry Herfindahl Index by a significant amount. Calculations indicate that the index increases by only 5% for the total U.S Market and as high as 6% for Region 5.

1993 Shipment Share	Total	Region 1	Region 2	Region 3	Region 4	Region 5
Philip Morris	42.21	43.80	39.77	40.84	42.49	44.85
RJR	30.57	24.12	34.55	34.09	30.09	29.26
B&W	10.96	7.80	9.93	13.51	10.78	13.30
Lorillard	7.08	14.29	7.15	3.10	6.74	3.82
American	6.75	7.84	6.63	5.55	6.77	6.96
Liggett	2.42	2.13	1.94	2.88	3.10	1.79
Herfindahl Index						
Philip Morris	1,782	1,919	1,582	1,668	1,806	2,011
RJR	934	582	1,194	1,162	905	856
B&W	120	61	99	183	116	177
Lorillard	50	204	51	10	45	15
American	46	61	44	31	46	48
Liggett	6	5	4	8	10	3
Total Index	2,938	2,832	2,973	3,061	2,928	3,111
B&W	10.96	7.80	9.93	13.51	10.78	13.30
American	6.75	7.84	6.63	5.55	6.77	6.96
Combined Share	17.70	15.64	16.56	19.07	17.56	20.26
B&W/AMB Share Squared	313	245	274	364	308	411
Raises the Index by:	148	122	132	150	146	185
New Index	3,086	2,954	3,105	3,211	3,074	3,296
% Increase to Index	5.0%	4.3%	4.4%	4.9%	5.0%	6.0%

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